The **BEPS** Monitoring Group

Comments on the

STATEMENT ON A TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY

On 1 July 2021 a statement was issued by the OECD outlining the agreement reached through the Inclusive Framework of the OECD/G20 base erosion and profit shifting (BEPS) project. These comments by the BEPS Monitoring Group (BMG) aim to contribute to a wider public understanding of the issues involved. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on our previous reports, and has been drafted by Sol Picciotto with comments and contributions by Abdul Muheet Chowdhary, Jeffery Kadet, Annet Oguttu, Sudarshan Rangan, Attiya Waris, and Francis Weyzig.

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SUMMARY

This agreement is historic in accepting for the first time the need to apply a formulaic method to apportion at least part of the total global profits of the MNEs concerned, complemented by proposals for a global anti-base-erosion tax. These elements point a way forward to further reforms that could be comprehensive and long-lasting.

However, as presently formulated Pillar One is only a stop-gap solution, creating a special tax regime for only around one hundred of the largest and most profitable MNEs, and allocating only a small share of their profits. The vast bulk of MNEs' profits would continue to be allocated under the current inappropriate and ineffective rules. While its initial limited scope may be necessary for political reasons, the aim should be to create a basis for a more comprehensive and long-term solution.

The global minimum tax proposed in Pillar Two could be transformational, but as currently designed would be unfair and ineffective for MNE host countries. The priority given to home countries in the GloBE, coupled with the low minimum rate of at least 15%, would not remove the incentive for MNEs to shift profits out of source countries which mostly have rates of 25% or higher. Although an additional source taxation right is now stated to be 'an integral part', its scope is still uncertain, and it would have an even lower rate of 7.5-9%, which is also its maximum. This is lower than the existing withholding tax rates in the vast

majority of treaties, so host countries would gain nothing unless it is actually included in the minority of treaties with lower withholding tax rates, and its scope is expanded. There is a formal commitment for participating countries to accept treaty changes, but only for countries that are also participating, and if they are classified as developing countries. Unless Pillar Two can be redesigned, a better solution for MNE host countries would be to change all their tax treaties to allow taxation of all payments, including those for automated digital services, based on Article 12B of the UN model. Since treaties with low withholding tax rates would lose any value they might have for source countries, the threat of cancellation should facilitate their renegotiation.

While this agreement is a significant step forward, it should not preclude a continuation of work on wider reforms, and countries should retain their rights to adopt measures more suited to protecting their tax base. Negotiations must continue, in this and other forums, to achieve reforms that could ensure that MNEs are taxed where their economic activities occur. A common approach to a global minimum effective tax rate requires a common approach to the allocation of undertaxed profits. These complex interacting rules should be replaced by a substance-based allocation of the rights to tax undertaxed profits.

GENERAL REMARKS

This agreement attempts to forge a political consensus around a package of proposals that have emerged over the past two years in the latest phase of the G20/OECD BEPS project. This period has seen a more determined attempt to reform international tax rules to ensure that multinational enterprises (MNEs) can be taxed where their economic activities occur, as mandated by the G20 leaders in 2013. The only way to do this effectively, as we have argued, is to treat MNEs in accordance with the economic reality that they operate as unitary enterprises under central management and control, and to allocate their profits to be taxed according to factors that reflect their real activities in each country.

The agreement is historic in accepting for the first time the need to apply a formulaic method to apportion at least part of the total global profits of the MNEs concerned, under Pillar One. This is complemented by the Pillar Two proposals for a global anti-base-erosion tax (a GloBE) which could ensure that profits declared in jurisdictions where they are taxed below an agreed minimum rate would be taxed at that rate. These elements point a way forward to reforms that could be comprehensive and long-lasting. However, the agreement has serious limitations and design defects, which would damage lower-income countries in particular. If treated as the endpoint of negotiations, it could block progress towards effective change.

As presently formulated Pillar One is only a stop-gap solution to the problem of allocation of MNE profits for tax purposes. It creates a special tax regime that would apply to only around one hundred of the largest and most profitable MNEs, and would allocate only a small share of their profits. The vast bulk of MNEs' profits would therefore continue to be allocated under the current inappropriate and ineffective rules.

In our view, the current design of Pillar One should be treated as only an interim measure. Negotiations should continue to design rules fit for the 21st century, along the lines that have already been proposed during the negotiations, particularly by developing countries. This could take place in the Inclusive Framework and/or in other forums. For example, countries should amend their tax treaties to allow taxation of all income from automated digital services based on the new article 12B in the UN Model.

The Pillar Two proposals could be more effective than Pillar One, and could help to coax reluctant states to consider more effective reforms. The design has improved since the version in the OECD's blueprint last October, by recognising that the priority for home country

taxation in the GloBE is unfair and unacceptable to countries that are mainly hosts to MNEs, which are generally lower-income countries. In our view, however, the solution envisaged remains problematic, its combination of a relatively low minimum rate and complex interacting rules would not effectively deter MNEs from shifting profits out of home or host countries to achieve a global effective tax rate significantly out of line with where it has real activities. We welcome the indication in the communiqué of the G20 Finance Ministers that the consultation process with developing countries will continue, as an improved design would benefit all countries.

In our view, a far better approach would be to revise the GloBE to provide a balanced allocation of the rights to tax undertaxed profits, by applying a substance-based allocation, which could be applied by all countries simultaneously to both inbound and outbound investment, as put forward in the proposal for a minimum effective tax rate for multinationals (METR).[1]

SPECIFIC COMMENTS

Pillar One

Scope

This statement has now rightly abandoned the attempt to limit the scope to defined sectors, 'automated digital services' (ADS) and 'consumer facing business' (CFB). These limitations ignored the findings of the previous reports under Action 1 of the BEPS project that digitalisation has affected the whole economy, and has only exacerbated the flaws of international tax rules. The limitations to specific business segments would also have been difficult to administer, and a source of confusion and conflict.

However, this agreement would only create a special and distinct regime for around one hundred MNEs within its scope. Thus it has been estimated that, despite the widening of sectoral coverage, increasing the size threshold to €20b turnover and a 10% profit rate would mean that Pillar One would still only affect $100b of profits, around the same as projected for the OECD blueprint of 2020.[2] The agreement provides for application to a business segment which meets the size and profitability threshold, though only in 'exceptional circumstances', and this could be avoided through accounting allocations between segments. Taking into account also the additional threshold of in-country sales (€1m, reduced to €0.25m for countries below €40b GDP), there would be relatively little additional tax revenue, especially for small countries.

The agreement is an admission that the current rules are seriously defective. Yet, the remedy it offers is just an arrangement to make monetary adjustments mainly among the richest countries, which would mostly cancel each other out.[3] While it would establish a new formulaic method for allocating profits, this would cover only a very small number of

[1] See Cobham A, Faccio T, Garcia-Bernardo J, et al. (2021) A Practical Proposal to End Corporate Tax Abuse: METR, a Minimum Effective Tax Rate for Multinationals. IES Working Papers 8/2021: IES FSV. Charles University.

[2] Devereux M and Simmler M (2021) Who will pay Amount A? *EconPol Policy Brief* 36, p. 4. A higher figure has been estimated of $130b, but this includes revenue from Amazon's cloud computing (which would be covered by the proviso for business segments above the thresholds), and seems also not to have excluded regulated financial services: Laffitte S, Martin J, Parenti M, et al. (2021) Taxation of Multinationals: Design and Quantification. Conseil d'Analyse Economique.

[3] See Robert Goulder (2021) The Cost of Change, Part II: Rethinking U.S. Exposure to Pillar 1, *Tax Notes International* 19 July, 103: 381-385.

corporate groups, and a small part of their profits. Although these MNEs may be the most profitable at any given moment, there is no principled case for singling them out for distinctive treatment. Indeed, those covered would vary from time to time, so may move in and out of the special regime.

Furthermore, the very high global revenue threshold means that very many highly profitable MNEs that have a significant economic presence in small and low-income countries would remain out of scope. Although a lower threshold of in-country sales has been conceded for these countries, this is only a second filter applying to MNEs at or above the initial size and profitability test. As the comments from the G24 have pointed out, the rationale for the thresholds aims to balance administrative simplicity with intended benefits, but this has been done from the perspective of large countries. Under this agreement, smaller and lower-income countries will see little benefit from Pillar One. There would not even be a review of these scoping rules for seven years, which would kill any real hopes for such countries of significantly benefiting from this process.

While Extractives and Regulated Financial Services are distinctive, simply excluding firms by applying a sectoral definition would be problematic. The exclusions proposed in the October blueprint were for 'natural resources' and 'financial services', and the criteria were based on determining whether the activities were within the ADS or CFB categories. Since scope will be now be determined by the size of the corporate group, the exclusion of these sectors poses the question of how to treat groups only parts of which engage in these excluded activities. New criteria will be needed to determine the treatment of firms that are mainly, for example, commodity traders, or energy businesses. Similarly, many large financial firms only have parts engaged in regulated financial services.

The agreement states that 'segmentation would occur only in exceptional circumstances', but refers only to situations where 'a segment meets the source rules'. It seems that the same should apply if some of the activities of a group are excluded, but the remainder meet the source rules. It is clearly important that any inclusion or exclusion of segments from the scope of Amount A should not be ad hoc but based on clear principles. Yet this will be difficult because the adoption of quantitative thresholds, while in some respects an administrative simplification, is a pragmatic and not a principled decision.

The approach adopted would leave in place the current defective methods for taxing MNEs based on the fiction that the affiliates of MNEs operate independently and at 'arm's length' from all the others. These methods are diametrically opposed to the formulaic method proposed for Amount A. Yet they would continue to apply even to the one hundred MNEs covered by the new regime in respect of most of their profits. The agreement suggests that market jurisdictions would share 20-30% of the profits above 10%, which means that 73-82% of the total income of these highly profitable MNEs would still be allocated under current rules. Furthermore, the remainder of the approximately 8000 largest MNEs currently covered by country-by-country reporting (those with revenues over €750m) would be entirely unaffected, let alone the many thousands more that have a significant impact especially in countries with smaller economies. This is no way to create international tax rules fit for the 21st century.

A principal motivation for this agreement is the need to resolve conflicts resulting from the proliferation of unilateral measures adopted by states, particularly digital services taxes. Yet the abandonment of attempts at a more comprehensive reform would inevitably result in a further proliferation of such measures, particularly by lower-income countries whose finances have been drained by the pandemic. For example, financial services, which have been excluded, are highly profitable, and are likely to be the target of special taxes in many

countries. The same applies to other sectors that are economically important, especially to lower-income countries, such as telecommunications. MNEs of all sizes will find themselves subject to increasingly strict audit, creating uncertainty due to the ad hoc and subjective nature of existing transfer pricing rules.

This agreement could be a breakthrough, but only if it is regarded as a step towards a more comprehensive system that could remedy the defects of the current rules. The work now needed to implement the agreement would establish important technical building blocks to apply a formulaic method for allocating MNE income. These include the definition of the tax base of each MNE's global consolidated profits, and methods to define the allocation factors, particularly sourcing rules for the sales, personnel and asset factors needed for the formulaic allocation of Amount A and the substance-based carve-out in Pillar Two. These issues should be addressed with the aim of widening their application in a comprehensive way that would reform the rules for all MNEs, and not just as a special and exceptional regime for a handful.

The narrow scope is also due to the anticipated difficulties of implementation. Above all it would require not only the conclusion of an international agreement but its ratification, as well as necessary amendments to national law, entailing legislative approval in many countries. Such a political effort could only be justified if the proposals opened the way to a wider and more sustainable reform of international tax rules.

Hence, in our view this agreement could be accepted only if its narrow scope and other limitations are seen as provisional: a first step leading to a more comprehensive long-term solution. Conversely, countries should not accept it if this would preclude work on wider reforms or prevent the adoption of measures more suited to protecting their own tax base, such as article 12B of the UN Model Tax Convention. Furthermore, such work should begin now, and not be postponed for the seven years envisaged for the review of the turnover threshold. It will be recalled that in 2015 the OECD requested a further five-year extension for the work on Action One, but the work resumed in earnest following political pressure in 2018. It is essential that political pressure should spur continued work now for a comprehensive reform.

The concession granted for some developing countries to apply an elective binding dispute resolution mechanism instead of mandatory binding dispute resolution, is a welcome recognition of the unsuitability of relying on binding dispute resolution to resolve conflicts caused by unclear or inappropriate rules. However, we see no reason for this to be limited to countries 'that are eligible for deferral of their BEPS Action 14 peer review and have no or low levels of MAP disputes'. The aim should be to design Amount A so that it can be administered jointly by the countries concerned, so that disputes do not arise. Agreement on Pillar One should not entail the extension of commitments to accept mandatory binding dispute resolution beyond Amount A. Arbitration taking place in secret cannot command public confidence, and the use of domestic courts and tribunals whose decisions are open to taxpayer and public scrutiny should be a priority. In general, the aim should be to prevent disputes by adopting rules that are clear, simple and easy to apply.

Design

The continuing work should include a serious evaluation of proposals that would provide a better basis for such wider implementation. In particular, we support the proposal put forward by ATAF to calculate the profit to be reallocated as a portion of the MNE's total profits rather than only its excess or 'residual' profits. As ATAF pointed out, this would be far easier to administer, hence facilitating application to all MNEs, perhaps above a de minimis threshold.

More fundamentally, the ATAF proposal challenges the assumption that the 'residual' profits of MNEs are mainly attributable to their home countries, while activities elsewhere around the world only result in 'routine' profits. This view entirely overlooks that MNEs derive their super-profits from the synergies due to their global coordination of activities located in the most suitable locations, and to the economies of size and scope allowing them to dominate markets around the world. The proposals partly accept this by proposing a formulaic allocation to 'market' jurisdictions, but only for a few of the largest MNEs, and with no principled rationale for the amount apportioned. It does not take into account the fact that MNEs also have many important activities other than sales outside their home countries, including research and development networks and production facilities.

The home-country perspective is also evident in the statement that the simplified method proposed for determining the attribution of profits to 'baseline marketing and distribution activities' (Amount B) would be based on the arm's length principle. This implies that it would aim to allocate only a 'routine' level of profits. The concept is based on the 'one-sided' methods usually deployed to apply the arm's length principle (particularly the transactional net margin method), which treat subsidiaries as 'stripped risk' entities. In reality, MNEs operate in an integrated way, and it is the group as a whole that both bears the risks and obtains the benefits of their global reach.

A wider approach was also put forward by the G24 developing countries, which proposed a formulaic apportionment approach in their original submission on taxation based on 'significant economic presence' in 2019. While the concept of apportioning MNEs' global profits has now been adopted, it would apply only to sales. As the G24 proposal pointed out, an apportionment methodology should apply a balance of supply-side and demand-side factors, reflecting each MNE's real activities in each country in production (employees and assets) as well as consumption (sales). Allocation of profits based on sales is justified by the principle that sales are essential to realise profits, and on the practical grounds that customers are relatively immobile, and sales-based taxes do not discourage job-creating inward investment. Indeed, some advocate a 100% sales-based allocation.

The negotiations have shown that there is wide support for a significant allocation weighting for sales, although agreement has not yet been reached on the figure. The statement suggests it could be between 20-30% of the profits over 10%, which means 18-27% of the total profits. This is quite a wide range, but even the top end seems a low allocation for sales. ATAF has proposed 35% and the G24 has called for a profit escalator mechanism where up to 50% would be redistributed if the MNE had higher Profit Before Tax (PBT) margins.

Negotiators should aim to reach agreement on the broad principles of allocation, which in our view should be one-third each for sales, employees and assets under most circumstances. The specifics of calculating both factors and weightings should be developed based on these broad principles, with suitable adaptations for different economic sectors and business models. For example, for extraction of minerals and other primary products, sales should be attributed to the exporting country. For a sector where one of these three factors is not relevant, only two factors could be applied. For example, an internet platform business for which physical assets are small relative to the size of the business would apply only the employee and sales factors.

A more general formulaic approach would be much easier to administer than the present proposal. In particular, it would avoid the need to manage the interaction between Amount A and the allocation of the remaining profits.

The current proposals envisage a 'marketing and distribution profits safe harbour'. This seems intended to protect MNEs from a theoretical double-inclusion of non-routine profits through inclusion of such profits in both Amount A and in the base for direct taxation due to an existing taxable presence within a market or host country. Many MNEs have profit-shifting structures that will undoubtedly continue in the future given that the Pillar Two applicable minimum will very likely be lower than the headline tax rates in most MNE home countries. These profit-shifting structures typically include limited-risk taxable presences within market and host countries to specifically limit local taxation to profits from routine functions. Recognising this reality, any 'safe harbour' must be designed to be only applicable when there is legitimate double-taxation of non-routine profits. Accordingly, the 'safe harbour' should be *expressly* not applicable where inter-company agreements or other arrangements have limited the responsibility of local personnel and operations to routine functions.

More important than double taxation is double non-taxation. The design of Pillar One provides only a limited solution to one of the central problems that Action One aimed to address, the ability of many MNEs to derive substantial revenues from countries backed by extensive marketing and distribution activities that can be delivered remotely. As an example, an MNE markets and distributes a TV show, collects payments, and addresses consumer grievances, all remotely and with no or limited local physical presence. Under the present approach, if the MNE is in scope, then the taxing right to the market jurisdiction is limited to a small share of non-routine profits, Amount A. The 'routine' profits normally attributed under current rules for the marketing and distribution activities themselves would not be taxed in the country where they are delivered, and can easily be attributed to entities in countries where they are subject to low or zero taxation. If the MNE is out-of-scope, then market country taxation is completely denied under current rules requiring a physical presence. *This is patently unfair considering that the very purpose of these discussions is to address the problem that many businesses have been able to operate remotely and fully escape market country taxation.*

As proposed by the G24, in the case of in-scope MNEs, market jurisdictions need not only a share of non-routine profits, but also a 'return for deemed performance of certain activities like baseline distribution and marketing of digital goods and services for remote sale activities in a jurisdiction.'[4] The entire focus of Action 1 is on the effects of digitalisation in further facilitating business activities with little or no physical presence, which has greatly undermined the tax base of source countries. Hence, in principle in-scope taxation must be a share of all profits and not only non-routine profits, as proposed by ATAF. Until a more comprehensive solution is agreed, progress towards this could be made by adopting the new article 12B developed by the UN Tax Committee that would allow taxation of income from automated digital services and other reforms to the central problems of taxable presence and income allocation that have been exacerbated by digitalisation of the economy.

Further, since the proposal's scope is so limited and many out-of-scope MNEs would be of significant size in relation to many of their market countries, it is clear that market countries should be allowed to retain their DSTs or other tax base-protection mechanisms for application to such MNEs. Thus, any obligation to refrain from DSTs and other such mechanisms should be only with respect to their application to in-scope MNEs. This is particularly important for the lower-income countries that would gain little from the proposal as currently formulated.

[4] See also the Statement by the South Centre.

It should be recognised that the above-mentioned 'safe-harbour' as well as many of the other complications of the Pillar One and Two proposals would be unnecessary under a comprehensive formulaic methodology. Such a methodology would greatly simplify international tax rules, and provide certainty and predictability for both tax administrations and MNEs. There would be far fewer disagreements, since the methodology would be based on principled, objective, location-specific, and quantifiable criteria, rather than the present subjective and ad hoc evaluations of the 'functions performed' and 'risks assumed' by different entities within an MNE corporate group. Any conflicts that did arise could be more easily resolved, and this could guarantee that only the MNE's actual global profit is taxed.

Implementation

Pillar One has been greatly simplified to make implementation easier. Nevertheless, this remains highly problematic, as it will require changes to treaties and to domestic law. Thus even if members of the Inclusive Framework exert their best efforts this will take some time, while non-members have no obligation to participate. The design of Amount A requires 100% ratification by all nexus jurisdictions, which may or may not be IF Members. This can never be guaranteed. In fact 100% ratification cannot be guaranteed for any treaty in any forum. Uneven implementation will make it very difficult to apply the Pillar One scheme.

Hence, it is unclear when participating countries will actually begin to collect revenue from Amount A. The arrangements for phasing out unilateral measures will need to take this into account, countries should not be obliged to give up taxing rights in exchange for promises which may prove illusory. Furthermore, as stated above, the withdrawal of alternative measures should not extend to groups that do not fall within the scope of Pillar One.

Pillar Two

The agreement attempts to resolve the key issue of allocation of the rights to tax undertaxed profits in a way that is more balanced than in the October 2020 blueprint, but would remain complex and difficult to implement. We welcome the acceptance that there should be prior rights to tax income in countries at source, where it derives. However, the current proposals would remain unfair to MNE host countries and ineffective in ensuring competitive equality, as they would continue to encourage MNEs to shift profits out of host countries and reduce their global effective tax rates below the standard rates applicable in most countries.

Rules and Rule Order

Its main element, the GloBE, continues to give priority to an income inclusion rule (IIR) to be applied by each MNE's home country, while host countries could only apply the undertaxed payments rule (UTPR) as a fallback. An olive branch is proposed, offering host countries a subject to tax rule (STTR); this would give them additional rights to tax some payments, but its scope has not been finalised, it minimum rate is lower than that of the GloBE, and it would depend on changes to be made to tax treaties.

Firstly, the STTR would apply only to 'certain' related party payments. Although inclusion of interest and royalty payments has been agreed, the statement refers to 'a defined set of other payments' which are yet to be specified. In our view, the STTR should expressly apply to *all* intra-group payments, including all kinds of royalties, fees for services, and capital gains. Attempting to limit the scope to only some kinds of payments is a recipe for confusion and conflict, as the categorisation of payments for royalties and fees for services has been notoriously problematic. Tax treaties already generally allow withholding taxes on payments of interest, royalties, and in many cases fees for technical services. What is lacking in existing treaties is the right for countries to tax payments for automated digital services, which was

the main motivation for BEPS Action 1. Unless its scope is extended to all payments, treaty revision to allow the STTR would be pointless.

Secondly, the minimum rate for the STTR is proposed as between 7.5% to 9%, though it seems this is still under negotiation. The lowest minimum rate agreed for the GloBE of 15% is twice the lower end of the range for the STTR minimum rate. Furthermore, *the STTR minimum rate is also a maximum*. The agreement states that under the STTR 'the taxing right will be limited to the difference between the [STTR] minimum rate and the tax rate on the payment'. Under the Pillar Two blueprint (paragraph 571), the STTR would be included in treaties as an additional taxing right over and above both taxes on business profits and withholding taxes. Under the agreement, any taxes imposed under the STTR would be considered covered taxes under the GloBE rules for the jurisdiction of the payee, so the STTR has a first priority.

However, the blueprint also provides that withholding taxes would be attributed to the receiving entity in calculating its effective tax rate (ETR). The proposed STTR range is below the typical withholding tax rates negotiated in tax treaties by developing countries, which for interest and royalties are generally 10% or 15%, and sometimes 20%.[5] Many developing countries also have treaties that permit withholding taxes on fees for technical services, at a rate of 10% or higher. Hence, where typical withholding taxes have already applied, the ETR of these payee entities will be above the minimum for the STTR to apply at all. *This means that, as currently formulated, the STTR would most often not result in any additional taxing rights under the vast majority of tax treaties*.

Thus, any benefit from the STTR would depend on countries that have negotiated treaties with lower withholding tax rates amending them to provide for the STTR. The STTR is described as an 'integral part' of achieving consensus on Pillar Two, and there would be a political commitment for participating states to accept the necessary treaty changes. However, this is limited to 'developing IF members', and only for IF members that have nominal corporate income tax rates below this 7.5% to 9% range. Hence, this commitment would not extend either to non-members, or the many countries that are mainly hosts to MNEs but fall outside the developing country category. There are many countries outside this category that are mainly capital-importing, and so may not be able to apply the STTR. In any case, given its current limitations, they may not wish to do so. Improving the scope of source country taxation is the best way of ensuring the widespread acceptance of Pillar Two, beyond the large states that are the main MNE home countries.

Even if these amendments were implemented, the STTR rate would be lower than typical withholding tax rates. In our view, it would be easier and more effective for countries that have agreed treaties with low withholding tax rates to renegotiate or cancel them, since such low rates would no longer be appropriate. The application of the IIR by MNE home countries under the GloBE would end any advantage that some host countries thought they would gain by offering low or zero withholding tax rates in any treaties. Although we favour a redesign of Pillar Two based on a formulary substance-based allocation of taxing rights, an alternative could be to include commitments for states to accept suitable withholding taxes as part of the package.

The lower STTR minimum rate and the cap for the STTR would in effect confirm the GloBE's division of the rights to tax undertaxed profits between home and host countries. For the source country to be able to apply the full 15% (or higher) GloBE minimum effective tax

[5] See the Tax Treaties Dataset published by the International Centre for Tax and Development, available at www.treaties.tax (columns AH to AM).

rate, it would have to apply first the STTR, and then the UTPR once it had determined that no IIR had been applied by a home country to the relevant income. This would create unnecessary and undesirable complexity.

The agreement states that the implementation plan would include a multilateral instrument to facilitate its adoption. It 'contemplates' that Pillar Two should be 'brought into law' in 2022, to be effective in 2023. It would be unprecedented for such a multilateral convention amending existing bilaterally negotiated treaties to be ratified and implemented in national law so quickly. Approval of legislatures can involve significant difficulties in many countries, and in some federations may require approval and legal changes at sub-state level, notably in Switzerland. It is likely that the MNE home countries which have treaties that are the most restrictive for host country taxation would be the most reluctant to change them unilaterally to allow the STTR. The Statement says that such treaties would be amended if requested by a developing country IF member. It should be clarified how this would be enforced.

Effective implementation of Pillar Two would also require amendment of some existing tax treaties, to introduce the switch-over rule. This is not mentioned in the statement, with no reason given. Just as the STTR requires countries to respect a treaty partner's request for an STTR amendment to an existing treaty, requests by any country for amendments to apply the switch-over rule should receive the same respect by treaty partners.

The current design of Pillar Two involves complex interactions between the IIR, the UTPR and the STTR. These seem unnecessary and undesirable, and seem to result from the assumption that the primary right to tax undertaxed profits should go to the MNE's home country, hence the priority for the IIR within the GloBE. If anything, the priority should be for the UTPR, but a balanced method is needed. We note also that the agreement states that there may be 'deferred implementation' of the UTPR. No reason is given, and this is also problematic.

The GloBE can be adopted quickly, as participating states have agreed that it does not require treaty changes. The STTR has been included as an olive branch, but only for developing countries, and with a lower minimum rate than for the GloBE. The many source countries applying DSTs and other similar arrangements would be required to terminate them.

This seems to us to be an unequal bargain. Source countries are entitled to defend their tax base, and can do so unilaterally or by jointly developing suitable common standards. Such measures can be devised to be compatible with tax treaties, or incompatible treaties could be cancelled if necessary. We recognise that any negotiation requires a degree of give-and-take. However, there appears to be far more 'give' than 'take' for source countries in this package, yet these are generally the lower-income countries.

Hence, it seems to us that many of these countries will see no good reason to restrict themselves by adopting either the GloBE or the STTR as currently designed. They should in our view explore alternative ways to protect their tax base before agreeing to sign on to this package. This could include revision of their tax treaties to ensure that they allow suitable withholding taxes on all base-eroding payments, including payments for the use of software, technical services, and automated digital services, as provided in articles 12, 12A and 12B of the UN model. The Inclusive Framework should support those countries which consider such solutions more appropriate for them, and should not adopt an agreement that would prevent them from doing so.

In our view, a common approach to a global minimum effective tax rate requires a common approach to the allocation of undertaxed profits, to deal adequately with the problem of base-eroding payments from foreign operations being routed through intermediary entities to

arbitrage country differences to ensure low taxation. The attempt to resolve this through these complex interactive rules would be ineffective, as long as there remain a combination of low-tax jurisdictions, jurisdictions not implementing the IIR, and jurisdictions subjecting profits to at least the minimum ETR but not implementing the UTPR for its residents' outbound payments.

A far better solution would be to revise the design of the GloBE so that it could provide a balanced allocation of taxing rights, as put forward in the proposal for a minimum effective tax rate for multinationals (METR).[6]

The Minimum Effective Tax Rate

We note that the statement says that it has been agreed that the minimum rate shall be 'at least' 15%. This clearly suggests that countries are free to adopt a higher minimum. Some governments have already expressed their desire to do so, including both developed and developing countries. It is notable that the Independent Commission for the Reform of International Corporate Taxation (ICRICT) proposes a minimum rate of 25%, which is in line with the current average corporate average tax rate, while the UN FACTI Panel recommended a rate of 20-30%.

The difference between a minimum rate of 15% and 25% is crucial to the design of Pillar 2 and to its likely effects. Since 15% is significantly lower than the prevailing rate in most countries, such a minimum would do little to incentivise MNEs to end profit-shifting out of source countries into low-tax conduit countries. The design of the GloBE and the STTR means a continuation of most existing profit-shifting structures, which would directly hit MNE host countries, and lower-income countries in particular. Only if the minimum rate for the GloBE were increased to at least 25%, and the rate for the STTR raised accordingly, could the longer-term aims be achieved of ending the shifting of profits from host countries. While home countries would make some immediate and continuing gains from the GloBE, due to its priority for the IIR, host countries would gain little or nothing, under either the UTPR or the STTR.

Some MNE home countries themselves appear to consider it to be desirable to maintain the competitive advantage to 'their' MNEs of being able to avoid host country taxes and reduce their global ETR below the rate they themselves apply domestically. This is unacceptable. A key objective should be to ensure international tax reforms that could restore competitive equality between MNEs and domestic companies in all countries. Tax advantages have been a major element in fostering corporate gigantism, which is difficult to control through competition policies alone. This particularly damages entrepreneurs in host countries faced with the enormous power of foreign-based MNEs that have become increasingly able to avoid local taxation.

As important as the rate is the methodology to define the effective tax rate. Although much technical work was presented on this important issue in the October blueprint, some key elements were still open for debate. These include in particular the treatment of accelerated allowances for depreciation and capital investment. The statement mentions only that the tax base will be 'determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences)'.

[6] See footnote 1 above.

It is very important that negotiators should resist pressures to rely on mechanisms that allow exceptions for incentives such as accelerated allowances. In addition to such allowances in some sectors allowing almost indefinite deferrals of tax, many MNEs have already integrated such allowances for artificially created intangibles into their BEPS structures. There must be a rigorous definition of the effective tax rate with attention to details that could spark competition by states to design allowances that benefit each state's 'own' MNEs or that inappropriately attract foreign investment.

A related issue mentioned in the statement is the treatment of distribution tax systems, which was discussed in section 3.3.6 of the Pillar Two blueprint:

> In respect of existing distribution tax systems, there will be no top-up tax liability if earnings are distributed within 3 to 4 years and taxed at or above the minimum level.

We can accept the logic that profits that are certain to be taxed within a short period of time at a rate that is equal to or higher than the agreed minimum rate should escape both the IIR and the UTPR. However, a period that defers paying tax for 3 to 4 years is simply too long. Further, if the domestic rule only imposes tax upon the declaration or payment of a dividend, then the timing of any tax payment is in the hands of the MNE and may extend even beyond the expected 3 to 4 years.

Considering this situation, we believe that the suggested approach in paragraph 228 is much too liberal. This approach would allow a current increase in covered taxes with recapture if the taxes are not actually paid within some reasonable period of time, e.g. 2-4 years. While we believe that the best approach would be that only actual taxes paid are included in covered taxes, it is reasonable to allow inclusion in covered taxes of any actual taxes paid within no more than fifteen months following the yearend of the taxpayer. Any taxes paid later would be treated as covered taxes in the year of payment.

The carve-out for a level of profits attributed to activities with substance would also weaken the effects of a minimum tax, particularly one fixed at the relatively low rate of 15%. It is legitimate, in principle, for countries to decide the appropriate tax rate for income from activities that physically take place in the country, measured by a standard rate of return on tangible assets and payroll, as proposed. It is important, however, that such tax advantages should be provided on a non-discriminatory basis to both local and foreign investors, and not used merely to create zero- or low-tax enclaves for MNEs. The limited effects of the disciplines on incentives under BEPS Action 5 on Harmful Tax Practices prompted the need for a global minimum tax, so it is important that this carve-out should not further weaken Pillar Two.

Hence the methodology must be rigorous and its application capable of being strictly monitored. The carved-out tax base of 7.5% of the carrying value of tangible assets and payroll, reducing to 5% after five years, suggested in the agreement seems reasonable, provided in particular that tangible assets are appropriately valued. However, we are concerned that the statement refers to 'at least' those rates, implying that higher percentages could be used by a jurisdiction to protect material amounts of MNE profits from inclusion in the calculation of that jurisdiction's undertaxed profits. The determination of the level of profit allowable for the carve-out should not be left to the discretion of either MNEs or governments that provide incentives. A better way to ensure that countries retain the right to determine their own tax rate is to revise the GloBE to apply a common substance-based allocation of the right to tax undertaxed profits, as proposed in the METR.

Transparency will be key to the effective implementation of a minimum tax, to prevent both avoidance by MNEs and competition among states to provide advantages that circumvent the

basis for calculation of effective tax rates. MNEs' published financial accounts are often opaque particularly on tax aspects. Although MNEs are now required to prepare country by country reports on a worldwide basis, they are designed only for risk assessment and only available to tax authorities, while most lower-income countries do not yet have access to them. The template for these reports should be revised to include the information needed to implement Pillar Two, and the reports should be made public.

The effectiveness of Pillar Two will greatly depend on the design of its elements and their combination. A minimum rate of 15% is still very low in relation to the current worldwide average rate of 25%, and countries may still seek to compete by providing generous allowances and incentives unless the tax base definition is strict and the carve-out is limited. Above all, the system of interacting rules is complex, unfair and ineffective, and should be replaced by a substance-based allocation of the rights to tax undertaxed profits. A common approach to a global minimum effective tax rate requires a common approach to the allocation of undertaxed profits.